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SUBJECT: TEN BIRR: THE BLACK MARKET HERALDS THE CURRENCY
DEVALUATION

¶1. SUMMARY: In a shift from historic patterns, Ethiopia's currency, the Birr, has been significantly depreciating recently against major hard currencies including the U.S. Dollar in the black market. Government of Ethiopia (GoE) officials attribute the depreciation to shortages in supply and the ever increasing demand for these foreign currencies. Following the depreciation of the Birr in the black market, monetary authorities have also allowed a depreciation in the inter-bank market from Birr 9.04/\$1 to Birr 9.28/\$1 in the same period. The rate in the black market shops are quote driven -- having now reached 9.9 Birr/\$1 -- reflecting largely demand and supply conditions.

BACKGROUND

¶2. Like most countries, Ethiopia's foreign exchange market has dual components -- the official inter-bank market and the black market. The inter-bank market is managed by the National Bank of Ethiopia (NBE) as it deems necessary to smooth excess volatility in the market. Traditionally, the official rate of the Birr against the U.S. dollar maintained a steady crawl of approximately 0.0001 Birr per day, and the premium between the official and black market rate was not significant. An exception was in the aftermath of the 2005 election when a substantial swing was triggered by speculation. At that time, the GoE took administrative measures such as requiring the forfeiture of foreign currency notes from passengers at the airport to ameliorate the pressure on the black market Birr/\$ exchange rate and bring it back in line with the official one.

¶3. In contrast with the past, the Birr in the black market has been depreciating significantly against major hard currencies such as the U.S. Dollar, Euro, and Pound Sterling owing to shortages in their supply and the ever increasing demand for these foreign currencies. The Birr/\$ rate in the black market has been depreciating markedly from Birr 9.50/\$ at the beginning of December to Birr 9.90/\$ in beginning February 2008, indicating a record of 4.2 percent depreciation in just three months. Following this, the monetary authorities allowed a sizable depreciation in the inter-bank rate from Birr 9.04/\$ to Birr 9.28/\$ over the same period.

SUPPLY AND DEMAND CONDITIONS

¶4. A preliminary study conducted by the NBE indicates that the reasons for the recent surge in the black market rate are both supply and demand side factors. On the supply side, sources of foreign currency in the black market are border trade with Sudan and Somalia and informal remittances through friends, relatives and businessmen mainly from the U.S., Europe and the Middle East. NBE's assessment indicated that the currency of the border trade with Sudan changed to Euros instead of dollars due to U.S. sanctions, and border trade with Somalia is curtailed by tensions in the region. Thus, there is a decline in the supply of foreign currency notes into the market.

¶5. On the demand side there is an increasing demand for foreign exchange for several reasons: (1) to finance franco valuta imports (official imports that have not been allocated foreign exchange by

banks) such as importing cement for the booming construction sector, (2) to finance contraband imports, for which payment is required in hard currency, (3) under invoicing imports mainly from India and China, and (4) for speculative purposes to hedge against the rising inflation and exchange rate depreciations either by hoarding locally in foreign currency or saving abroad. Macroeconomic indicators such as the 18 percent annual CPI inflation, the negative 14 percent real interest rate on savings, and the absence of alternative investment opportunities like securities markets erode people's confidence to save in local currency and hence prompt the hoarding of foreign currencies

¶16. A senior economist at the NBE, who wishes to be anonymous, estimated the total annual remittance inflow to Ethiopia in the range of \$1.5 to \$2.0 billion. Close to \$600 million is transferred through the official channels while the balance comes through informal ways. This suggests the number and volume of transactions held by the black market operators is significant. The number of black market shops in Addis Ababa that buy and sell foreign currencies has increased significantly in the past few years. Post's Economic Specialist observed some shops busy exchanging currencies in large volumes and large numbers of transactions. Despite the increase in the number of these illegal shops, particularly in Addis Ababa, the GoE is not taking measures to control the black market. This leads some people to assume that the GoE uses this market to tap the informal inflows and increase its supply of foreign exchange.

¶17. The exchange rate in the black market is determined by demand for, and supply of, foreign currencies. A person working in a black market shop, located near Ethiopia Hotel in Addis Ababa, told Post's Economic Specialist that the rate in the black market shops are largely determined by the volume and number of orders placed by customers.

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¶18. COMMENT: Adjustments in an exchange rate reflect performance of an economy. Ethiopia's export receipts fall far short of financing the country's huge import bill. The country largely depends on foreign assistance and other inflows to finance its hunger for fuel, capital goods, food, and other imports. The increase in the size of the black market and the heightened depreciation of the Birr versus the dollar may signal a wariness among the public regarding Ethiopia's future economic stability. The pressure on the depreciation of the local currency risks continuing unless government is committed to move forward in liberalizing the economy, enhance private sector investment and attract more foreign direct investment. END COMMENT

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